# Indexing Capital Gains by Fiat

By Bruce Bartlett


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Bruce Bartlett is a former Treasury deputy assistant secretary for economic policy and author of the recently published book *The Benefit and the Burden: Tax Reform — Why We Need It and What It Will Take*.

In this article, Bartlett reviews the history of efforts to index capital gains using the government's regulatory authority. Although the Treasury and Justice departments rejected earlier efforts to so index capital gains, some legal scholars continue to argue in favor of indexing and say the case for it is now stronger legally than it was when it was first raised in 1992.

Once again, congressional Republicans are pushing for indexing of capital gains.[1] Perhaps in anticipation of a renewed fight on that topic if Mitt Romney becomes president, Republican legal theorists have revived the idea that the Treasury Department has the authority to index capital gains for inflation by regulation without additional legislation.

The impact of inflation is a well-known problem. Because taxes apply to nominal gains, those that arise solely as the result of inflation are taxed along with real gains. In periods of high inflation, the tax can easily exceed the real return, resulting in confiscatory effective tax rates on realized capital gains. Many studies have documented that effect.[2]

For that reason, a long line of tax theorists, including Robert M. Haig, Henry C. Simons, Jacob Viner, Richard A. Musgrave, Richard Goode, and Joseph A. Pechman, have held that taxes should apply only to real gains and not the inflationary component.[3]

Historically, Congress has partially justified excluding a portion of capital gains from taxation or taxing them at a lower rate than ordinary income as a way to compensate for the effect of inflation on gains that was simpler and easier to implement than indexing. For example, when Congress increased the capital gains exclusion from 50 to 60 percent in 1978, the Joint Committee on Taxation offered as one rationale:

> In addition, the Congress believed that an increased capital gains deduction would tend to offset the effect of inflation by reducing the amount of gain which is subject to tax. However, since the deduction is constant, unlike the adjustments generally provided for in various indexation proposals, it is much simpler and should not tend to exacerbate inflation.[4]

The administrative ease of simply having a lower rate on capital gains in lieu of indexing is critically important. All capital gains indexing schemes introduce a great deal of complexity to the tax code. For example, choosing the appropriate price index is not easy, given that the Consumer Price Index often undergoes revisions and is commonly believed to overstate the true rate of inflation. Matching gains and losses would be far more complicated than it is now. It also would be necessary to index interest rates to inflation to prevent capital gains indexing from creating tax arbitrage opportunities.[5]

Despite the difficulties and complexities involved in capital gains indexing, conservative business people and economists have long argued that it is extremely important and will deliver enormous economic benefits. *The Wall Street Journal* frequently

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[1]Meg Shreve, "Lawmakers Search for Vehicle for Indexing Capital Gains," *Tax Notes*, Apr. 30, 2012, p. 555, *Doc 2012-8739*, *2012 TNT 80-2*.

[2]Bruce Bartlett, "Inflation and Capital Gains," *Tax Notes*, June 2, 1997, p. 1263, *Doc 97-15496*, *97 TNT 105-65*.

[3]*Id.*

[4]JCT, "General Explanation of the Revenue Act of 1978," at 252 (1979). Note that one common criticism of all indexing proposals in the 1970s was that they would diminish the pain of inflation and thus tend to make it worse.

[5]For more discussion and other complications, see Reed Shuldiner, "Indexing the Tax Code," 48 *Tax L. Rev.* 537, 566 (Spring 1993); New York State Bar Association Tax Section Ad Hoc Committee on Indexation of Basis, "Report on Inflation Adjustments to the Basis of Capital Assets," *Tax Notes*, Aug. 6, 1990, p. 759.

runs articles and editorials saying so.[6] Former Treasury economist Gary Robbins, who often analyzes Republican tax proposals, estimated that indexing capital gains and depreciation beginning in 1992 would have created close to 1 million additional jobs and added $2.7 trillion to the nation's capital stock and $1.6 trillion to the GDP by 2000.[7]

Frustrated at Congress's unwillingness to enact capital gains indexing or cut the tax rate, in January 1992 Republicans hit on the idea of having Treasury enact indexing by fiat by using its regulatory authority to redefine the word "cost" for establishing basis to mean inflation-adjusted cost. It's not entirely clear where the initial idea came from; according to a *Wall Street Journal* editorial, it "emanated out of the Justice Department's policy shop."[8]

In the first serious analysis of the proposal, professor Lawrence Zelenak, then at the University of North Carolina Law School, suggested that while there was no legal basis for indexing capital gains by regulation, it would probably withstand court challenge because no one would have standing to sue.[9]

The National Taxpayers Union Foundation and the National Chamber Foundation then contracted with Shaw, Pittman, Potts & Trowbridge lawyers Charles Cooper,[10] Michael Carvin, and Vincent Colatriano to offer a legal opinion on whether Treasury in fact had the authority to index capital gains unilaterally without congressional action.

Not surprisingly, the lawyers concluded that Treasury did indeed have the authority to index capital gains, just as the organizations funding the study had expected. However, they admitted that their conclusion rested on an expansive interpretation of Treasury's regulatory authority.[11]

Both the DOJ and Treasury concluded that such authority did not exist, and the George H.W. Bush administration dropped the idea.[12] (I confirmed with Treasury's then-general counsel, Jeanne Archibald, that she had concluded independently that legal authority to index capital gains by regulation did not exist before the DOJ's Office of Legal Counsel came to the same conclusion.) Attorney General William Barr later responded to criticism that he had not been sufficiently supportive of the president's wishes on the issue, saying:

> There was a great deal of pressure — not from the administration but from writers and from Republicans on the Hill — to conclude that the president could index capital gains. There again, I paid close attention to the question that was being asked. [Syndicated columnist] Robert Novak wrote that the real problem was that I was not sent sufficient signals as to what answer was wanted. While I agree with Novak on many things, here he was mistaken. On the contrary, I was clearly told what the question was, which was, is indexing lawful. Also, I understood the policy preferences of the administration. The question was: Can we, simply through administrative action, index capital gains. And not only did I not think we could, I did not think that a reasonable argument could be made to support that position.[13]

Nevertheless, Republicans continued to assert that the president had the authority to index capital gains via regulation without congressional sanction. In 1996 Republican presidential nominee Bob Dole said he would immediately index capital gains if elected. As former chair of the Senate Finance Committee, he undoubtedly knew better but made the promise at the behest of his running mate, former Rep. Jack Kemp, who strongly supported the idea.[14] As recently as 2006, *The Wall Street Journal* editorialized that the president had the authority to index capital gains if he wanted to.[15]

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[6]Victor Canto, "Index Capital Gains — Now," *The Wall Street Journal*, July 27, 1999; op-ed: Theodore Forstmann, "Indexing Capital Gains, A Very Big Deal," *The Wall Street Journal*, Oct. 22, 1996; Richard Rahn, "Inflation and the Tax Man," *The Wall Street Journal*, Jan. 17, 2008; Michael Darda, "The Inflation Threat to Capital Formation," *The Wall Street Journal*, Apr. 10, 2008, at A15.

[7]Fiscal Associates, "Economic and Revenue Effects of Indexing Capital Gains and Depreciation 'Basis' for Inflation," memorandum for the U.S. Chamber of Commerce (Aug. 24, 1992). More recently, Robbins predicted vast economic benefits from the enactment of Herman Cain's 999 tax plan, which apparently was a recycled Robbins proposal from 1996. *See* Ben Smith, "Cain Study Recycles 1996 Paper," *Politico*, Oct. 21, 2011.

[8]"Presidential Indexation," *The Wall Street Journal*, Jan. 28, 1992.

[9]Lawrence Zelenak, "Does Treasury Have Authority to Index Basis for Inflation?" *Tax Notes*, May 11, 1992, p. 841.

[10]Cooper served as assistant attorney general for the DOJ's Office of Legal Counsel during the Reagan administration.

[11]"The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains," Aug. 1992. A version of this memorandum was later published in the *Virginia Tax Review* 631 (Spring 1993).

**(Footnote continued in next column.)**

[12]DOJ, Office of Legal Counsel, "Memorandum Opinion for the General Counsel, Department of the Treasury: Legal Authority of the Department of the Treasury to Issue Regulations Indexing Capital Gains for Inflation," Sept. 1, 1992, *available at* http://www.justice.gov/olc/archibal.23.htm. *See also* Lee Sheppard, "Some Other Reasons Why Treasury Cannot Index Gains," *Tax Notes*, Sept. 7, 1992, p. 1249.

[13]*Cardozo L. Rev.* 36 (Oct. 1993). *See also* Rowland Evans and Robert Novak, "A Presidential Test on Capital Gains," *The Washington Post*, Sept. 2, 1992, at A21.

[14]Richard Stevenson, "Dole Expands Capital Gains Tax Cut Plan," *The New York Times*, Oct. 23, 1996.

[15]"Counting Capital Gains," *The Wall Street Journal*, Oct. 3, 2006.

While Romney's views on this subject are as yet unknown, I expect that the same people who have been pushing capital gains indexing for decades will pressure him to support unilateral indexing — and there's a very good chance he will go along. He can cite for support a recently published article by Cooper and Colatriano in a respected academic journal arguing that not only was their earlier opinion correct, but that subsequent court cases have strengthened their argument.[16]

Not being a lawyer, I won't offer my own opinion on whether capital gains can be indexed to inflation by executive order. I do think it would be a bad idea politically. Regardless of which party controls Congress, it tends to jealously guard its prerogatives. I expect that even if Congress is under Republican control, the chairs of the Senate Finance and House Ways and Means committees would strongly recommend that indexing be done legislatively and not by presidential fiat.

[16]Charles J. Cooper and Vincent Colatriano, ''The Regulatory Authority of the Treasury Department to Index Capital Gains for Inflation: A Sequel,'' *Harvard J. of L. and Public Pol'y* 487 (Spring 2012).